

## This Time It IS Different

***Synopsis: With the U.S. debt downgrade and the sovereign debt crisis in Europe, is there a risk-free rate of return left anywhere in the markets? What does that mean for pension funds and anybody whose process relies on CAPM and the efficient frontier?***

***Takeaways: The entire investment opportunity set may be repricing risk through a process somewhat less efficient than groping in the dark. If the highest returns are achieved by investing in the riskiest assets, how do we respond to a world where the traditional hierarchy is in flux?***

Where did the sudden choppy waters in the investment markets come from? None of the usual explanations seem to apply. There has been no significant change in the fundamentals of U.S. or international equities in the past few weeks. A double-dip recession is still given less-than-even chances by most economists. Interest rates are low and look like they'll stay that way. The European debt crisis may hit banks in the teeth and threatens the euro, but why should it affect the valuation of European stocks, much less their U.S. counterparts? The people on Wall Street seem to regard the downgrade of U.S. government debt as something of a joke, and Treasuries have actually rallied since the announcement.

So what gives?

Robert Levitt, of Levitt Capital Management in Boca Raton, FL (and various European locations), has an interesting

explanation. In fact, he thinks that the newsletter you are now reading somehow managed to miss the biggest single investment story of the past 50 years: the death of a brilliantly workable explanation for how investments should behave, otherwise known as the Capital Asset Pricing Model.

Levitt's thesis is straightforward, and it covers all the bases. Start with the idea that suddenly, as of the last few weeks or months, institutions have no clear "risk-free rate of return" to plug into their CAPM and efficient frontier models. The traditional risk-free asset was the U.S. Treasury bond obligation. Whatever you may think about the S&P downgrade, few investors can ignore the possibility that there will be another ugly debt ceiling debate, and most of us will forever recall the words of some participants in the last Congressional food fight, saying that it might not be such a

bad thing if the U.S. defaulted on its sovereign obligations.

Beyond that, many institutional investors (and not a few advisors) will agree with Levitt, who says: "In our opinion, Treasuries, which are now paying less than 2%, are about to become the short of the century as soon as interest rates start going up."

Of course, the investment universe could shift its risk-free investment to something else. Or could it? One by one, Levitt demolishes the alternatives. Money markets? "Most of them are paying zero interest," Levitt points out. "And when you look at their portfolios, they're filled with European banks. Is that risk-free? Why would you own a money market fund that pays you nothing, and is filled with the debt of European banks that may be technically insolvent?"

It's even easier to brush aside government bonds denominated in euros. "If you are a French pension fund or a French bank, your risk-free rate would be a European sovereign government bond," says Levitt, "and that clearly has lots of risk now. Look at the Greeks."

Could you put your money in the bank? Well, do you think banks are stable beyond the FDIC insurance that backs them? How stable were Lehman Brothers and Bear Stearns? How sure are you that the mortgage paper banks are holding will be worth what it's valued at?

Okay, what about Proctor & Gamble bonds, which are

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now more highly-rated than U.S. Treasuries? At this point, you've moved the risk-free investment into a less deep and liquid market. Could China move its sovereign debt holdings into P&G bonds, or into corporate bonds altogether?

Meanwhile, Levitt says that CAPM is under simultaneous attack from another direction, which is precisely illustrated by this inversion of riskiness between corporate and government debt. "Under the traditional mean/variance theory, the emerging markets should have more volatility, because they should be inherently more risky," he says. "So in the event of a market decline, the frontier market stocks are supposed to have the higher beta and go down more."

But that, of course, hasn't been the case recently. The emerging and frontier markets are enjoying an unprecedented period of stability (and fiscal responsibility) while the developed world teeters on various brinks of debt-related chaos. "Indonesia, one of my favorite markets, came very close to a record high yesterday," says Levitt. "I own a rubber company in the Ivory Coast which is very similar to a rubber company that trades in France. Right now, the Ivory Coast company is at record highs in line with its record earnings. The French company is down thirty percent. I saw that John Deere was down 7% the same day it reported blowout earnings," he continues. "Its customers, farmers, are having one of their best years ever. The company's customers

are in great shape, its balance sheet is in great shape, there is not an excess of inventory, the growth is unbelievable, yet the company falls 7% in one day."

The point here is that the whole pyramid-like hierarchy of risk vs. return has been subverted in ways that are not yet understood with any degree of certainty. At the apex of risk and return were the frontier stocks, but now, suddenly, there is more volatility and uncertainty among European blue chips. As we saw earlier, corporate bonds are suddenly looking less risky than government-issued debt around the world, and some sovereign debt (like Greek government bonds) are yielding more than U.S. junk bonds.

"That is not in the theory that we all learned," Levitt points out. "When we studied CFA 101, we learned that there were gradations of risk. It doesn't exist today in those nice neat little packages. When you have less risk in a corporate bond than in a government bond, when you have less risk in a frontier stock than in John Deere, then all the rules that the pension funds and institutional money managers have relied on are not valid any more."

If you combine these two frontal attacks on CAPM, in just the right mix, you get exactly what we're seeing in the marketplace today. Pension funds are suddenly unable to apply their traditional investment models in the traditional way. "The market is trying to price in all these new risks," says Levitt. "But until it gets it right, you're going to have this huge volatility going on. When people have no

idea how to assess the situation," he adds, "they tend to dump risk assets."

But where do they put the money? Treasuries, money market funds, sovereign European debt and bank deposits are not attractive options for reasons cited earlier. If the entire fixed income market tried to shift from Treasuries and their European equivalent to AAA-rated corporates, it would be like the population of Asia suddenly deciding to relocate to Delaware.

Okay, so maybe investing isn't so bad after all. After the latest nasty downturn (so the thinking might go), U.S. (and, maybe, global) stock prices are attractively priced. What do investors do when they see attractively priced risk assets in a market where there are no palatable risk-free investment alternatives? They buy.

Congratulations. You've just constructed a theoretical basis for the current rollercoaster, which Levitt expects to continue until some Ph.D. student comes up with a new model. "I really can't predict what the new theory will be," he confesses. "But it's really important for everyone to understand that the old model is probably not coming back, and that they need to think about how they're allocating their clients' assets, and maybe thinking about doing some things in nontraditional ways."

Levitt Capital Management currently has \$500 million under management, chiefly from wealthy families in Europe, the U.S. and South America. Even though Levitt doesn't have a clear idea of what will replace CAPM, he does have a big picture theme that he believes

will help him navigate through the choppy waters ahead. "Our whole firm has been focused, for the last 11 years, on the world shifting away from the developed markets to the developing markets," he says. As reported in a prior issue of this newsletter, Levitt leans his investment portfolios toward ways that the world is changing most rapidly and profoundly. So, for example, he will buy newspaper companies in Africa as this new (for them) communications vehicle is introduced into certain African cultures. He buys companies that will benefit from the transition of a billion Asians from poverty to middle class life, like the makers of indoor plumbing and farms that provide meat to the middle class diet.

As these companies have grown, LCM has returned a composite 10.3% per year, annualized, over the last three years, and 12% a year from inception. (By way of comparison, the U.S. market is down 1.84% annualized over the same time period.) But don't expect Levitt to post big returns this year. "Right now," he says, "we want to take as little exposure as possible. We are net short in U.S. equities, long in Asia, but not with a lot of exposure. As a financial advisor, I don't need to be a hero. People just want to avoid losing money in this kind of market."

Even though our interview subject has his assets on the sidelines, this is one of those unsatisfying articles where there is no clear prescription. I'm not sure I can recommend Levitt's approach because I'm not sure most advisors



*"I'm here to look into your home office deduction."*

could do it the way he does. (Levitt has *visited* that rubber plantation on the Ivory Coast, and his last due diligence trip was to Rwanda.)

This much we know: Stocks are going on periodic fire sales, which have traditionally been good times to buy. But the idea that we no longer have a tool to assess the risks is enough to give any professional investor pause. If Levitt is right, and I suspect he may be, then it's time to rethink how portfolios are constructed, and more importantly, we all need to

hunker down and expect that the current storm of volatility to go on much longer than these things have lasted in the past.

Normally, our position at this newsletter is to ridicule anybody who says this time it's different. But there are undeniable differences in today's market than anything we've seen in the recent past, and Levitt's description of the underlying causes--and his idea that CAPM might be dead or in the emergency room--have a clear and frightening ring of plausibility. ■